Bank Restructuring and State Aid Control

Mathias Dewatripont

National Bank of Belgium*

and

ECARES and Solvay Brussels School

(*Université Libre de Bruxelles*)

EARIE Conference 2013, Evora

* The views presented here are not necessarily those of the NBB

Outline

1. Brief history of banking crises and banking regulation.
2. State Aid Control and bank bailouts since 2008.
3. The European banking crisis in international perspective
4. What about current regulatory initiatives on recovery & resolution, bail-in and State Aid Control?

Brief history of banking crises and banking regulation: The unending search for optimal bank regulation

Until the Great Depression

- Almost century-old 'cycling' between three objectives: (i) 'efficient' banking; (ii) financial stability (at least, no bank runs); (iii) fighting moral hazard ('no bail-outs').
- Until 1930's: sacrifice (ii), financial stability, but with many bank runs, in particular in the Great Depression.

The era of strict regulation

- From mid-1930's to early 1970's: sacrifice (i), efficiency, through strict limits on competition (i.e. on entry, size, prices and activities); and introduce deposit insurance.
- Led to no more bank runs and no bailouts but low productive efficiency in banking (e.g. overbranching) and the development of nonbank competitors, like Money Market Mutual Funds.

Gradual deregulation

- As a result, gradual deregulation since the 1970s, on prices and entry but also on size and portfolio of activities, while keeping deposit insurance (to try and guard against financial instability) and focusing on (risk-based) bank solvency (to try and guard against moral hazard), through Basel I and II capital ratios.

The deregulation record

- Since the 1970s, many banking crises (147 worldwide according to *Laeven-Valencia*, IMF, 2012).
- Of course, many linked to macro imbalan-ces, but also (esp. in industrial countries) exacerbated by bank behavior, especially when they are undercapitalized and 'gamble for resurrection' (easier for banks to do it than for regular firms, when they have access to 'safe' funding and just need to raise interest rate on deposits).

The deregulation record (2)

- Interest rate and entry deregulation did benefit customers, but at times at expense of financial stability.
- On the other hand, mixed picture at best, both w.r.t. size and scope (do big (univer-sal) banks make profits and offer high wa-ges due to scale/scope economies or to market power and 'too-big-to-fail' subsidy?) and on innovation (ATMs at one extreme, very complex new financial products at other).

The deregulation record (3)

- On the other hand, clearly, solvency in 2008 was insufficient (and so was liqui-dity): Basel I/II capital requirements could not prevent the crisis.
- Problem both of level of capital ratio and of ability of banks to ‘manage’ it (internal models, securitization, …).

The deregulation record (4)

- Interestingly, until 2008, most banking crises post 1930s have avoided bank runs, because deposit insurance and bailouts have been the rule.
- Then came Lehman, i.e. a bankruptcy that triggered systemic 'wholesale' bank runs that prompted a huge wave of bailouts (+ the rise of 'explicit' deposit insurance for retail deposits, in the EU to €100,000 per bank per depositor).

Reregulation: busy reform agenda

- Mix of (i) continuity (with recalibration) and (ii) change: (iia) back to regulation of what a bank may/should be; (iib) introduction of 'system regulation'.
- (i) More and better capital (and an additional, simpler, leverage ratio).
- (iia) Liquidity ratios, recovery & resolution plans, large-bank surcharges, structural reforms (Vickers, Volcker, Liikanen).
- (iib) Macroprudential instruments (Countercyclical Capital Buffer, ...).

Assessment of current situation (1)

- Reform agenda makes sense given pre-vious crisis. Does involve a partial U-turn w.r.t. laisser-faire approach to banking activities.
- Impact of new approaches (liquidity, reco-very & resolution, structural reforms, sys-temic approach to regulation) still untested.

Assessment of current situation (2)

- Debate continues on 'excessively low Basel III capital ratios' (e.g. Admati-Hellwig, 2013) vs 'difficulty of finding the money & risks to real-economy lending'.
- Important debate in Euro area today. Would be desirable to have better-capitalized banks. Question: How? How fast?

State Aid Control and bank bailouts since 2008

Some General Remarks

- EU is alone in the world in having State Aid control.
- Rationale: externalities + 'protecting Member States against themselves'.
- Concerning externalities, banking is special, in particular in a systemic crisis: In this sector, help for a competitor can help rather than hurt a bank, if this avoids financial instability.

Assessment (1)

- Response in 2008-9 did take banking specificities into account: permissive for general-support schemes, 'remedies' focused on 'outliers' (*Beck et al.*, 2010, *Pisani-Ferry & Sapir*, 2010).
- Did help fight moral hazard (and reduce tax-payer cost!): bailouts were attached to tough remedies for viable banks (e.g. KBC in Belgium; of course, nonviable ones are costly, e.g. Dexia).

Assessment (2)

- However, at times remedies at the cost of 'distorted competition' (e.g. "no price leadership"): better to have been able to insist on stricter recapitalization without 'tying the hands' of bailout recipients.
- Key question today: how to take into account macroeconomic specificities in some Member States?
- Anyway, DG-Competition has different mission than a 'pure resolution authority'.

The European banking crisis in international perspective

Today, risk of panics (much) reduced (for now) but crisis not over

- Markets clearly less pessimistic, but GDP growth remains a big concern.
- We are not in 2008 any more, but can we avoid a 'Japanese decade' where growth just stopped?
- Note that Euro area today has *lower real GDP* than in 2008 ...

Banking crisis outcomes

(% of GDP; Source: *Laeven-Valencia*, 2012)

Area	**(Gross) fiscal cost***	**Increase in debt****	**Output loss*****
Japan (1997)	14.0	42	45
Sweden (1991)	3.6	36	31
USA (1988)	3.7	11	0
USA (2007)	4.5	24	31
Euro area (2008)	3.9	20	23

*: committed funds, to date (but (almost) fully repaid in the case of Sweden, & USA 2007).

**: three years after the crisis; ***over 3 years, relative to trend.

Some lessons

- Of course, many things can happen with GDP and public debt. But crises typically lead to very low growth (with potential vicious circles). Exception: US S&L crisis (more 'regional').
- Gross fiscal cost is only a fraction of debt increase.
- Why was the end outcome in terms of fiscal cost so much worse in Japan but also in S&L crisis than in the US in 2007 or in Swe-den (where most of it got reimbursed)?

The Japanese crisis (1992-?)

- Familiar starting point: burst of real estate and stock market bubbles, followed by a vicious bank-real-economy link (see for example *Hoshi-Kashyap*, 2004).
- Key problem: insufficient recapitalization led banks to hide losses and favor loss-making existing corporate customers rather than more promising new borrowers. Such 'zombie lending' (aka forbearance) led to less entry of new firms and a collapse of productivity (*Caballero et al.*, 2006).

The Swedish crisis (1991-3)

- Crisis fuelled by banking deregulation and a real estate bubble.
- Dealt swiftly through nationalization of big banks (with shareholders being wiped out). No lingering undercapitalization, thanks to availability of public money (which was repaid in the end).
- Growth was significantly helped by international growth and sharp depreciation of currency.
- See for example *Jonung* (2009).

Two contrasting US examples

- Savings and Loan crisis of the 1980s: much smaller than recent one to start with, but procrastination for many years, with accounting gimmicks instead of recapitalization (FSLIC did not have money at the time, Congress was unwilling to help ...), while losses mounted due to gambling for resurrection by S&L's (see for example *Dewatripont-Tirole*, 1994).

Two contrasting US examples (2)

- Current worldwide crisis did originate in the US, with the (real estate) subprime complex products.
- Still, the US is now in better shape than Europe.
- Key to this was TARP (Trouble Asset Relief Program) in 2009, which disbursed $428 billion, but is thought today to imply a net cost for the taxpayer of ... only $21 billion, or 0.1% of US GDP ! (*CBO estimate*, May 2013).

Euro area

- Two different crises since 2008: (i) ‘sub-prime-Lehman’ (trading book) crisis, which mainly affected Northern Europe; (ii) Euro (and Spanish housing) crisis, which mainly affects Southern Europe.
- The first one was somehow dealt with ‘US-style’, even if more gradually. Question: e-nough or not? The second one is still a ‘mo-ving target’, since depends on GDP evolu-tion. For those reasons, Banking Union will start with a Balance Sheet Assessment.

Conclusion

- Procrastination has a really big cost (see also *Diamond-Rajan*, 2009).
- Instead, swift intervention may be a good investment for the taxpayer (even if ex-post net-cost computations may fail to take into account risk premia).
- Tradeoff current/future crisis: do try and fight moral hazard, but this is NOT worth delaying restructuring, since this will most probably raise the final cost for taxpayers because of lower GDP growth !

Potential impact of current regulatory initiatives (R&R, bail-in and State Aid Control for banks)

Single Resolution Mechanism

- Banking Union is clearly helpful, but Single Supervisory Mechanism is only a first step: need Single Resolution Mechanism (SRM) AND sufficient backstop funding (for resolution and deposit insurance).
- Discussion of optimal degree of centralization/mutualization of SRM beyond this keynote address.
- Commission has clearly shown its ability to ‘discipline’ banks. Be careful however about multiple, potentially conflicting, missions.

Recovery and Resolution Directive

- More clarity on recovery and resolution clearly needed. And so is better resolvability, to limit Too-Big-To-Fail syndrome (impact on moral hazard and on competition).
- Be careful though about "bail-in trend": do not forget cost of financial instability ! Real solution is to have sufficient long-term loss - absorbing capacity (potentially VERY costly to rely on short-term debt discipline!)

New State Aid Control provisions

- More conditionality for acceptance of recapitalization plan with public money:

  1. Shareholders and junior creditors will need to contribute first.

  2. A restructuring plan needs to be appro-ved before recapitalization takes place.

- Exception possible when financial stability endangered; and 'fundamental creditor rights' need to be respected.

Some thoughts on these initiatives

- The start of the Banking Union offers an opportunity to 'restart the system', through its Balance Sheet Assessment (BSA).
- International experience suggests 'gene-rous' recapitalization of viable banks, to-gether with winding down nonviable ones, could be a very good (and even "profit-able") use of public money.

Some thoughts on these initiatives (2)

- Key to undertake a BSA that reveals hidden losses and either brings back viability through recapitalization or winds down nonviable institutions.
- Do not allow "bailout fatigue" to derail this process. Bail-in of creditors OK for institutions to be wound down, much less so for those to be restructured (‘gone’ versus ‘going concern’).
- Take sufficiently into account "exceptional macro circumstances" in restructuring plans, compensatory measures and own contribution.

General conclusion

- The "unending (cyclical) search for optimal bank regulation" continues, now with renewed emphasis of fighting moral hazard through bail-in.
- Do not allow such ‘bail-out fatigue’ to threaten financial stability. Do not forget Lehman: bail-in (even if predictable) fear can induce those who can run to do so.
- Key therefore to have sufficient "long-term loss absorbency capacity" to reassure the other (short-term) claimholders.

- While fighting moral hazard is of course desirable, it is important not only to fight the next crisis, but also to get out of the current one.
- International experience does suggest that swift recapitalization of viable banks and winding down of nonviable ones is key to restart the "growth engine", and thereby to limit taxpayer losses in the end.
- Do keep this in mind when embarking on the Banking Union !